Vendor Audit and Cost Recovery: Improving Bottom Line Results

WHITE PAPER

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LOCATIONS

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THE SCOPE AND NATURE OF OVERPAYMENTS

No matter how thorough your purchase controls, overpayments to vendors represent a business risk that directly affects your bottom line results. They are a fact of business life. People make mistakes and computers that process transactions repeat these errors until corrected. The larger an organization grows, the more complex its purchasing processes become, and the greater the risk of significant financial loss due to undetected and uncollected overpayments. Addressing this problem constitutes a large part of vendor audit operations.

Large businesses typically generate hundreds of thousands of payments to suppliers for transactions that may represent billions of dollars in annual expenditures. Government agencies, manufacturing and retail industries, in particular, may have many different and complex purchasing arrangements with large numbers of suppliers. Ensuring that every transaction has been processed correctly to align with an organization's policies and procedures can be a labyrinthine task involving the entire organization, multiple (and often, incompatible) computer systems, and a myriad of files. The sheer volumes of purchasing data and disparities among the departments and systems that handle them further exacerbate these difficulties.

The range of errors that can occur in overpayments is broad and can include:

- Miscalculations
- Vendors' pricing mistakes
- Duplicate payments
- Omitted discounts
- Neglected allowances and rebates
- Miscalculated freight charges
- Tax overpayment
- Non-compliance with sales agreements
- Charges for goods not received
- Charges for services not provided

Undetected, these errors can cost organizations the equivalent of one percent of their procurement budgets each year.

CURRENT APPROACHES TO COST RECOVERY AND VENDOR AUDIT

Companies use various types of cost recovery or vendor audit processes – first to identify errors made in payments to vendors or service providers, then to recover the amounts paid in error. Industries in which there is the greatest focus on recovery processes typically include retail, healthcare, and manufacturing. In the public sector, recovery process may actually be mandatory. For example, the US Erroneous Payments Recovery Act of 2001 requires certain executive agencies with more than $500 million in purchases to conduct vendor audits.

Traditional vendor audit procedures are time-consuming and therefore very expensive for the average organization to undertake with the required scale and thoroughness. And they are often not particularly effective. In a typical accounts payable department, vendor audit procedures may recover only 50 percent of overpayments. Remaining overpayments may never be recovered for a variety of reasons, including:

- Traditional methods may fail to detect the overpayments
- Overpayments may be disputed by suppliers
- Missing data or poor documentation can compromise the ability to support a claim

As a result, organizations frequently outsource vendor audit work to specialist recovery firms.

THE ROLE OF RECOVERY SPECIALISTS

Recovery specialists typically perform two distinct services: identification and recovery. First, they analyze an organization's data to detect suspicious transactions, and determine whether an overpayment exists. The second area of operation involves taking steps to actually recover the overpayments. This is generally the most time-consuming part of the process and where recovery specialists provide the greatest value.

The success rate of recovery specialists is usually between 0.1% and 0.4% of purchase volumes, or $1 million in recoveries for every $1 billion in expenditures. This service is not inexpensive. Specialist recovery firms typically charge fees or commissions ranging from 20 to 50 percent of the recovered amounts.

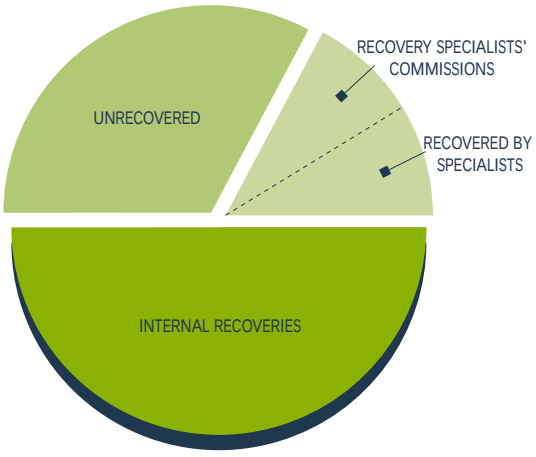

DIAGRAM 1: TRADITIONAL COST RECOVERY MECHANISMS

MAKING COST RECOVERY MORE COST-EFFECTIVE

The challenge, then, is increasing recovery of overpayment at a lower cost. Organizations can undertake more efficient internal efforts to identify overpayments before turning to external recovery specialists.

By taking a more proactive and focused approach to internal audit, organizations can detect a greater number of overpayments themselves and do it more quickly. Professional recovery specialists then can focus on the more sophisticated analyses required for complicated recoveries, as well as the recovery process itself. Organizations can maximize their return on expenditure by reducing the involvement of specialists in identifying overpayments.

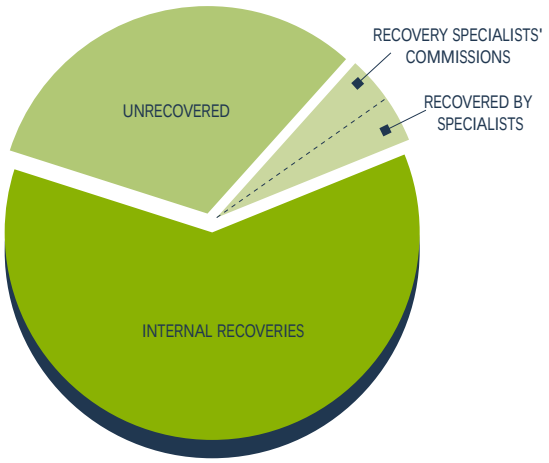

DIAGRAM 2: IMPROVED COST RECOVERY THROUGH DATA ANALYSIS TECHNOLOGY

To identify more overpayments more quickly in-house, organizations need a method for establishing a comprehensive vendor audit program and robust analytical capabilities that can fulfill the following functions:

- Reading, comparing, and logically linking multi-platform data outputs
- Swiftly executing complex tests on files containing hundreds of thousands, if not millions, of records
- Performing these tests on a continuous monitoring basis
- Accomplishing these tasks efficiently and at low cost

A leading high-end retailer used ACL to conduct a detailed analysis of their accounts payable files over two years and successfully recovered $2 million in overpayments.

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An international chain of specialized retail stores has replaced its outsourced cost recovery firm with an in-house vendor audit program using ACL technology.

Some of the primary types of data analysis tests designed to identify overpayments include:

- **Purchase order management**
  Begins the analysis process by identifying duplicate purchase orders and matching to corresponding invoices.

- **Vendor analysis**
  Reviews and ranks common vendors with high activity and dollar volume to gain an understanding of vendors and purchase attributes. Reports typically list all vendors, ranked by total dollar purchases within specified timeframes, providing details through such standard data fields as vendor number, name, cost, charge backs, number of invoices, net cost, and others.

- **Contract Pricing**
  The cost of good and/or services may be agreed in a contract to cover a period of time. Unless the actual changes/prices are compared to contract terms overpayments would/can go undected.

- **Item cost summary**
  Reviews first and last invoice date and lowest and highest cost charged to the item within the requested timeframe to identify unusual cost variances and isolate unfavorable pricing arrangements. Test reports list items by class, department, items purchased, cost, vendor, and difference, based on such standard data fields as class, item, description, number of invoices, early invoice date, low/high invoice cost, and others. Drill down functionality can be used to identify specific items. This can be valuable when multiple vendors are used to supply the same product/service.

- **Cash discounts**
  Compares the discount terms against disbursements to verify that discounts are taken in full. Organizations can maximize the value of cash discounts offered by vendors as incentive for specific payment timing through a more efficient payment cycle management review.

- **Anticipation of cash discounts**
  Confirms that anticipated cash discounts are properly reflected in vendor statements, with discounts immediately deducted from the invoice payment.

- **Cost difference**
  Identify invoices where the purchase order price was exceeded and for which the organization is entitled to a refund for overpayment. Run matching tests between invoices and purchase orders on key data fields within specificed tolerance ranges and timeframes.

- **Duplicate payments**
  Search using automated or ad hoc routines to identify duplicate payment of invoices and credit notes issued to adjust vendor charge backs. Check for duplicates based on document number, date, department, location, purchase order, or cost.

- **Price protection**
  Where vendors offer price protection by guaranteeing the lowest price, allow organizations to recover the price differential between what was paid and the new price for all goods on hand. Test to calculate "on hand" inventory and the price protection rebates available.

- **Taxes**
  Identify when vendor charged taxes to tax exempt organizations.

- **Advertising allowances**
  When vendors provide special allowances for volume purchases (goods ordered in excess of a negotiated dollar amount), truckload purchases (when full truckloads are ordered), and defective purchases (allowances in lieu of defective returns), tests can compare, order, and identify variances with negotiated terms.
- **Rebates**
  When vendors provide special terms, tests confirm organizations are receiving rebates to which they are legally entitled.
- **Unaccepted charges**
  Analyzes invoices to identify any unauthorized vendor charges – e.g. taxes, freight, non-billable items – through comparison with purchase contract terms.

Clearly, what is needed is a non-intrusive, cost-effective application that entails only a short learning curve for internal staff. Effective use of a specialized technology can assist staff in identifying a wide spectrum of overpayments due to error, oversight, or outright fraud, thus saving the organization time and money. This technology must be capable of rapidly reading transactional data in many different systems and of executing a range of tests against the data.

A global petrochemical company phased in a new ERP system to replace multiple legacy systems over a two-and–a-half–year period. During the migration, both the new and legacy systems ran in parallel, putting the integrity of accounts payable at risk. Both systems had controls for duplicate payments, but no such control existed between the two systems. Using ACL to review millions of transactions, the organization discovered nearly $900,000 of duplicate payments.

Furthermore, once these tests uncover overpayments, the organization can then identify the weaknesses that allow these errors to occur. Steps can be taken to improve internal control systems to prevent such losses from recurring. The long-term savings from implementing these corrective actions can be considerable. As well, improved control systems provide additional assurance over the payment process. This, in turn, can generate improvements to overall business processes.

By using continuous monitoring systems to test for overpayments, problems can be identified on a timely basis. Ideally, if the monitoring tests take place sufficiently close to the time of the originating payment process, potential errors can be corrected even before payments are actually made.

A telecommunications firm uses ACL to conduct regular analyses of expenditures for appropriateness, searching for irregularities and suspicious patterns or trends such as excessive transactions in a day and suspicious patterns concerning a particular location or user. In the initial nine months following ACL implementation, the company realized approximately $15 million in value-added recommendations alone. The company derives confidence from the analytic results, because the review is based on 100 percent of the data.

Faster and more comprehensive recovery, rapid identification, and correction of sources of error, and savings on fees and commissions can more than offset investment costs for appropriate software and implementation expertise.

FAST PAYBACK AND IMPROVED BOTTOM LINE RESULTS

ACL offers organizations low-cost, easy-to-implement solutions based on proven software that can access, analyze, and compare even the largest volumes of transactional data in a fraction of the time of currently available solutions. With ACL, continuous monitoring applications can be put in place quickly, to independently check and validate 100 percent of all data elements contained in the disbursement process. Overpayments are identified, and in many instances, prevented, through timely notification to management when transactions are suspected of falling outside acceptable parameters defined through internal controls and core business processes. The results: increased confidence and assurance in organizational disbursement processes and immediate improvement to bottom line results.